No. 22,400

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CHARLES H. LUNDQUIST,

Appellant,

vs.

JOE TURNER,

Appellee.

Appeal From the United States District Court
Central District of California.

APPELLANT'S OPENING BRIEF.

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Counter-Claimant and Appellant,

vs.

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Counter-Defendant and Appellee.

Appeal From the United States District Court
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APPELLANT'S OPENING BRIEF.

INTRODUCTORY STATEMENT.

This action was brought by way of counterclaim for monetary relief based on alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. Sec. 78(j)(b)) and Rule 10(b)-5 of the Rules and Regulations of the Securities and Exchange Commission (17 C.F.R. 240.10B-5). Jurisdiction is based on 15 U.S.C. Sec. 78aa and 15 U.S.C. Sec. 77v.

Counterclaimant Lundquist, as a purchaser of $420,000.00 worth of securities issued under a private offering exemption, sought damages against counterdefendant Turner, another member of the purchasing group,

for secretly selling part of the securities to a friend, secretly pledging the securities in violation of his investment representations, destroying the exemption and making Lundquist's securities worthless.

After a two-day trial, the District Court, without reaching the issues of damages or causation, found hat the conduct of Turner was not a violation of Section 10(b) of the Securities Exchange Act of 1934 nor was it a violation of Rule 10(b)-5 nor a violation of Section 17(a) of the Securities Act of 1933 (15 U.S.C. Sec. 77q), and entered judgment against Lundquist on his counterclaim, from which judgment Lundquist has appealed.

STATEMENT OF JURISDICTION.

1. The statutory provisions believed to sustain the jurisdiction of the District Court are Title 15 U.S.C.A. Sections 77v and 78aa.

Title 15 U.S.C.A. Section 77v provides that the District Courts of the United States shall have jurisdiction of offenses and violations under the Securities Act of 1933 and under the rules and regulations promulgated by the Commission in respect thereto and of all suits in equity and actions at law brought to enforce any liability or duty created by the Securites Act of 1933. Such suit or action may be brought in the District where the defendant is found or in the District where the offer or sale took place if the defendant participated therein.

Title 15 U.S.C.A. Section 78aa grants to the District Courts of the United States the same jurisdiction with respect to violations of the Securities Exchange Act of 1934 or the rules and regulations thereunder.

The jurisdiction of the Federal Court is independent of diversity and amount in controversy in such situation.

> *Deckert v. Independence Shares Corporation,* 311 U.S. 282, 61 S. Ct. 229, 85 L. ed. 189 (1940).

This United States Court of Appeals has jurisdiction to review the judgment in question by reason of Title 28 U.S.C.A. Section 1291 which gives jurisdiction to the Courts of Appeals of appeals from all final decisions of the District Courts of the United States and by reason of Title 28 U.S.C.A. Section 1294 which directs that appeals from reviewable decisions of the District Courts shall be taken to the Court of Appeals for the Circuit embracing the District Court.

2. The existence of jurisdiction of the District Court arises out of the following pleadings:

> (a) The Counterclaim of Charles H. Lundquist ("Lundquist" herein) [Rec. 2]*, which alleges that Turner violated Rule 10(b)-5 in connection with the purchase and sale of a security and in so doing used means or instrumentalities of interstate commerce and the mails [Rec. 20, 21];
>
> (b) The Notice of Appeal [Rec. 120].

*References to the Record on Appeal are cited herein by the abbreviation "Rec." followed by the page number.

STATEMENT OF THE CASE.

A. Statement of the Pleadings.

The case at bar against Appellee Turner arises under Section 10b of the Securities Exchange Act of 1934 and Rule 10(b)-5 of the Rules and Regulations of the Securities and Exchange Commission, 17 C.F.R. 240.10B-5.

The pleadings framing the issues involved in this case are:

(1) The Counterclaim of Lundquist [Rec. 20] filed as a part of his Answer to First Amended Complaint [Rec. 2];

(2) Turner's Reply to Counterclaim [Rec. 24].

Since the original action brought by Turner had been dismissed previously, the Pre-Trial Conference Order (which involved many matters unrelated to the Counterclaim) was not used in the trial of the Counterclaim; rather, the Trial Court asked for and received additional briefs and legal memoranda, consisting of:

(3) Trial Brief of Counterclaimant Lindquist [Rec. 39];

(4) Turner's "Plaintiff's Legal Memorandum" [Rec. 54];

(5) Opening Brief of Counterclaimant Lundquist on Questions of Turner's Violation of the Securities Acts [Rec. 62]; and

(6) Reply Brief of Counterclaimant Lundquist to Turner's Legal Memorandum [Rec. 91].

The Counterclaim is set forth commencing at page 20 of the Record on Appeal, and incorporates by reference portions of the Fifteenth Affirmation Defense in

the Answer commencing at page 13 of the Record on Appeal. The Counterclaim is framed in two causes of action, the first alleging that Turner engaged in conduct constituting a violation of 10b of the Securities Exchange Act of 1934 and Rules 10(b)-5 under that Act, causing Lundquist damage, and the second cause of action alleging that Turner set about to and did wreck United States Chemical Milling Corporation (herein called "the Company") in order to cover up his wrongdoing, and caused Lundquist additional damage. In his Reply, Turner sets up a general denial and urges that the Counterclaim fails to state a claim or a cause of action.

B. Statement of the Facts.

The facts are practically undisputed, and Turner admitted most of the matters upon which Lundquist seeks to establish his right to relief. In the following recitation of the facts, all references to the Reporter's Transcript refer to portions of Turner's own testimony unless otherwise indicated.

(1) The "Private Offering" Debenture Issue.

On about December 1, 1960, Turner signed a Debenture Agreement bearing that date [Ex. B]. He received it in the mail, read it, signed it, and mailed it back to the Company [R. T. 24, 25]*.

This agreement was between the Company, as borrower, and fifteen individuals, including Lundquist and Turner, as lenders, and provided for the purchase by the lenders of 6% ten year convertible notes (herein some-

*References to the Reporter's Transcript of Proceedings are indicated by the initials "R. T." followed by the page number(s) of the Transcript.

times called "debentures") of the Company in various amounts for the different lenders. Lundquist was to purchase $420,000.00 principal amount of notes, and Turner was to purchase $125,000.00 worth [Para. 2, p. 1 of Ex. B]. Lundquist's $420,000.00 subscription was comprised of $120,000.00 cash and $300,000.00 cancellation of indebtedness [Ex. B, p. 2].

The obligations of each lender, including Lundquist, to purchase the notes was conditional, and the agreement stated in part:

> "3. *Conditions.* Your obligation to purchase and pay for the Notes, or cancel indebtedness for the Notes, is subject to the satisfaction, on or before the date of closing, of the following conditions:
>
> "(A) You shall have received from counsel for the Company a favorable opinion, satisfactory to you and your counsel as to:
>
> * * *
>
> "(iii) The exemption of the sale and delivery of the Notes from the registration requirements of the Securities Act of 1933, as amended, * * *
>
> "(B) The representations and warranties contained in paragraph 9 shall be true on and as of the date of closing * * * with the same effect as though such representations and warranties had been made on and as of the date of such closing; * * * there shall exist on the date of such closing no condition, event or act which constitute an event of default as defined in paragraph 8; * * *"

Included among the representations and warranties of paragraph 9 was the following, appearing on page 12 of Exhibit B:

> "(F) Neither the Company nor any agent acting on its behalf (i) has offered the Notes or any part thereof or any similar obligation of the Company for sale to, or solicited any offers to buy the Notes or any part thereof or any similar obligation of the Company from, anyone other than yourself, or (ii) will sell or offer for sale the Notes or any part thereof or any similar obligation of the Company to, or solicit any offers to buy the Notes or any part thereof or any similar obligation of the Company from, any person or persons so as to bring the issuance or sale of the Notes within the provisions of Section 5 of the Securities Act of 1933, as amended."

Included among the events of default was the following language:

> "8. *Events of Default.*
>
> "(A) The occurrence of any of the following events will constitute an event of default:
>
> "(5) The Company has made any material representation herein, or otherwise in writing in connection with this Agreement and the transaction hereby contemplated, and any such representation shall prove to have been false in any material respect on the date as of which made;".

In December of 1960 and prior to the actual issuance of the Debenture, Turner received through the mails a letter from the Company [Ex. E]] which he read [R. T. 42, 43].

This letter advised Turner that the Commissioner of Corporations of the State of California had issued an appropriate permit authorizing the Company to sell and issue its 6% Subordinated Convertible Notes pursuant to the terms and provisions of the agreement dated December 1, 1960 executed by Turner [Ex. B] and further notifying Turner that the closing date would be January 3, 1961, and further advising Turner as follows:

> "The Commissioner of Corporations has required, in lieu of the Notes being escrowed with the Commissioner of Corporations as has been required in similar situations, that the Notes and Note Agreement be stamped with a notation to the effect that the Notes may not be transferred without the prior approval of the Commissioner of Corporations. Legal counsel has informed us that the notation of this restriction will appear only on the Notes and Note Agreement and will not apply to any common stock which may be received by you upon subsequent conversion of these Notes."

The permit of the Commissioner of Corporations [Ex. K] authorized the Company to sell and issue its securities to the fifteen lenders on certain conditions including the following:

> "(a) That the notes authorized by paragraph 1 hereof shall not be issued, executed, sold or offered for sale unless and until said notes shall have a legend thereon to the following effect: 'The sale or issuance of this note is authorized by a permit of the Commissioner of Corporations of the State of California and is subject to all of the terms

and conditions set forth in said permit and the owner of, or person entitled to the notes authorized to be sold and issued by paragraph 1 of said permit shall not consummate a sale or transfer of said notes, or any portion thereof, or receive any consideration therefor prior to conversion until the written consent or permit of the Commissioner of Corporations shall have been obtained so to do.'

"(b) That the owner of, or person entitled to the notes authorized to be sold and issued by paragraph 1 hereof shall not consummate a sale or transfer of said notes, or any portion thereof, or receive any consideration therefor prior to conversion until the written consent or permit of the Commissioner of Corporations shall have been obtained so to do."

Under date of January 3, 1961, the law firm of O'Melveny & Myers, counsel for the Company, issued to Turner and Lundquist and the other lenders named in the agreement of December 1, the legal opinion of said law firm in accordance with the condition set forth in paragraph 3(a) of Exhibit B. This legal opinion [Ex. J] stated in part as follows:

"On the basis of the foregoing examination and in reliance thereon and on all such other matters as we deem relevant in the circumstances, including our understanding that you are familiar with the business and financial condition of the Company, we are of the opinion that

* * *

"(iii) The offering, issuance, sale and delivery of the Notes is exempt from the registration requirements of the Securities Act of 1933,

as amended, pursuant to Section 4(1) thereof, as a transaction by an issuer not involving offering or sale;

* * *

"In rendering our opinion under (iii) above we are relying in your representations contained in paragraph 10 of the Agreement that you are purchasing the Notes for your private personal investment with no intention of reselling or otherwise distributing the Notes and that the shares of Common Stock which you may acquire upon conversion of the Notes will also be acquired by you for your private personal investment or for your own account, with no intention of reselling or otherwise distributing such shares."

Turner's representations contained in paragraph 10 of the Agreement, referred to in the foregoing legal opinion, are set forth on page 13 of Exhibit B and read as follows:

"10. *Representations of the Purchasers.* Each of you, severally and not jointly, represents and warrants, and in making this sale to you it is specifically understood and agreed, that *the Notes being acquired by you are being acquired and will be taken and received for your private personal investment for your own account with no intention of reselling or otherwise distributing the Notes* and that the shares of Common Stock which you may acquire upon the conversion of the Notes or any part thereof will also be acquired by you for your private personal investment for your own account with no intention of reselling or otherwise distributing such shares. You fully comprehend

that the Company is relying to a material degree on your representations and warranties contained therein and with such realization you authorize the Company to act as it may see fit in full reliance hereon. Each of you, severally and not jointly, does hereby indemnify the Company and agrees to hold it harmless from and against any and all damages suffered, and liabilities incurred by it, including liabilities for attorneys' fees, arising out of any inaccuracy in the representations, covenants and warranties made in this Paragaph 10." (Italics added.)

The Agreement further stated in Paragraph 11 (B) [p. 13 of Ex. B]:

"All covenants and agreements in this Agreement contained by or on behalf of *any* of the parties hereto shall bind and inure to the benefit of the respective legal representatives, successors and assigns of the *parties* hereto, whether or not so expressed." (Emphasis supplied.)

(2) Turner's Undisclosed Deal With Roland.

Prior to signing the Debenture Agreement of December 1, 1960 [Ex. B], Turner made a private agreement with Glenn Roland [R. T. 195] (a close friend of Turner's and who happened to be Secretary and Treasurer of the Company) that $25,000.00 of the $125,000.00 debenture purchased by Turner under the December 1, 1960 Agreement would be held for Roland, who was not one of the 15 lenders named in the Agreement. Roland agreed he would pay Turner $25,000.00 within a certain period of time [R. T. 32-33]. Turner did not tell any of the other fourteen persons

whose names appear on the Debenture Agreement that he was in fact purchasing $25,000.00 of the $125,000.00 purchase for Mr. Roland [R. T. 33-34]. Although Turner knew that the debenture issue was subject to the terms of a permit obtained from the California Commissioner of Corporations [R. T. 42], Turner did not advise the California Corporations Commissioner of any of his dealings with Roland [R. T. 44]. Turner also did not notify Lundquist at any time prior to the issuance of the debenture that he had an arrangement with Roland [R. T. 44], nor did Turner ever advise Lundquist or the Company that he had an arrangement with Roland concerning Roland's participation in Turner's debenture [R. T. 45]. Roland paid Turner the $25,000.00 as agreed a year later [R. T. 49], but by letter dated December 9, 1961 [Ex. F], and by financial statement given by Mr. Turner to his bank on January 18, 1962 [pages 96a and 96b of the deposition of J. R. Montgomery filed in evidence in this case] Turner was still representing that the full $125,000.00 face value of the debentures were solely his own and he did not disclose Roland's interest therein [R. T. 55, 60].

Lnudquist testified that he put $420,000.00 in cash into the Company, $120,000.00 of which was put in between December 1, 1960 and January 3, 1961. Lundquist testified he would not had paid in this $120,-000.00 had he not believed the debenture issue was going to go through [R. T. 116-117]. Lundquist testified he converted all of his debentures into common stock of the Company at $12.00 per share [R. T. 162] within a few months after the debentures were issued [R. T. 117], that he believed the debenture issue was

legal and valid and that on the date Lundquist converted his debentures into stock, he relied upon the opinion letter of O'Melveny & Myers [Ex. J; R. T. 119]. Lundquist further testified that on the date he converted his debentures into stock, he did not believe there was any defect, irregularity or illegality surrounding the debenture issue [R. T. 122] and that he gave up his short term loan position represented by the $420,000.00 he had advanced to the Company and accepted the subordinated long term debentures in the face amount of $420,000.00 in reliance on the validity of the debenture issue [R. T. 123] and that he converted his debentures into stock of the Company in reliance upon the validity of the debenture issue [R. T. 123].

There is no evidence in the record that anyone other than Turner and Roland themselves knew of the existence of this deal between Turner and Roland at any time prior to the commencement of this litigation. The District Court was satisfied that Turner did not disclose to anybody the fact that $25,000.00 of the $125,000.00 worth of debentures Turner purchased was to go to Mr. Roland [R. T. 224, 225].

(3) Turner's Pledge Agreement With His Bank.

Turner testified that J. R. Montgomery, who was Turner's Oklahoma banker, came out to California to see whether his bank should lend Turner the money to purchase the debentures [R. T. 26]. Turner arranged with the banker to borrow the money for the purchase of the debentures and for the ~~pleading~~ pledge of the debentures when purchased in order to secure the loan [R. T. 27], and by arrangement with the United California Bank caused the debenture to be transmitted to the

Oklahoma Bank with whom he had arranged financing [R. T. 34].

Turner never notified the California Corporations Commissioner that he had an arrangement to pledge his entire debenture purchase to the Oklahoma bank [R. T. 44-45], and he never notified Lundquist that he had such an arrangement [R. T. 45], and he never notified the Company prior to the filing of this lawsuit that he had made a pledge to the Oklahoma bank [R. T. 45-46]. Turner testified that the debentures formed only a part of the security for the $125,000.00 bank loan [R. T. 188], that the bank sent the loan proceeds to the Company and the Company sent the debentures to the bank [R. T. 188].

(4) Expert Testimony That Turner's Conduct Constituted a Violation of the Securities Laws and Rule 10(b)-5.

Graham L. Sterling, Jr., an attorney specializing in securities law, testified at length concerning his experience and qualifications. He testified that he reviewed the Debenture Agreement of December 1, 1960 [Ex. B], the debenture [Ex. C], the O'Melveny & Myers legal opinion [Ex. J] and the permit of the Commissioner of Corporations [Ex. K]. In response to a hypothetical question based upon the foregoing examination and the assumed facts that Turner, who signed the Debenture Agreement agreeing to purchase $125,000.00 worth, had by oral agreement with Roland agreed that $25,000.00 of said $125,000.00 debenture issue was to be purchased by Turner for the benefit of Roland, who had agreed to pay Turner $25,000.00 therefor in a year, and that Turner omitted to disclose his arrangement with Roland to any of the other fourteen lenders named

in the Agreement, and that instrumentalities of the United States mail and interstate commerce were used [R. T. 206-207], that in his opinion such conduct would constitute a violation of Rule 10(b)-5 [R. T. 209].

Mr. Sterling further testified that the pledge of the $125,000.00 debenture by Turner to his bank to secure the loan Turner made for the purpose of purchasing the debentures, which pledge was not disclosed to the other debenture buyers and was not preceded by a permit from the California Corporations Commissioner permitting Turner to pledge said securities, also constituted, in Mr. Sterling's opinion, a violation of Rule 10(b)-5 [R. T. 209-211]. Sterling further testified that in his opinion the debenture [Ex. C] is a security under Federal law [R. T. 211-212], and is also a security within the meaning of the California Corporate Securities Law [R. T. 212].

Mr. Sterling further testified that in his opinion, paragraph 11(B) of the loan Agreement [Ex. B] extended to the other purchasers of the debentures the civil remedies afforded under Section 10b of the Federal Securities Exchange Act [R. T. 219].

In response to a further hypothetical question [R. T. 221-222], Mr. Sterling testified that under the circumstances in this case Turner would be an "underwriter" within the meaning of the Federal Securities Act [R. T. 222].

(5) Posture of the Case When the District Court Ruled.

The District Court refused to hear any evidence of causation or damage unless and until it was in a position to hold for counterclaimant on the question of liability [R. T. 224], and the Court stated that unless liability was found under the first cause of action of the counterclaim, there would be no consideration of the other issues in the case [R. T. 179]. The Court asked for briefs on this issue and thereafter made its ruling without further evidence.

The Court found [Rec. 112-114] that Turner had at the time he purchased the debentures in the amount of $125,000.00, an agreement to transfer $25,000.00 worth to Roland for $25,000.00 cash which Roland did pay to Turner thereafter, and that Turner borrowed the $125,000.00 purchase price for his debentures from two Oklahoma banks and as security for the repayment of said loan, pledged the debentures and other assets to the banks. The Court found that this conduct was not a violation of Section 10b of the Securities Act of 1934, nor of Rule 10(b)-5 of the Rules & Regulations of the Securities Exchange Commission, and was not a violation of Section 17(a) of the Securities Act of 1933. The Court further found that Turner "did not employ a device, scheme or artifice to defraud; did not make an untrue statement of a material fact; did not omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and did not engage in any act, practice or course of business which operated as a fraud or deceit upon counterclaimant in connection with the purchase or sale of a security." The Court further found that Turner was

not an issuer or an underwriter within the meaning of the Securities Act or Rule X-10B-5, and accordingly entered judgment for Turner on the counterclaim of Lundquist.

C. Questions Presented.

The basic question presented is whether Turner's conduct in pledging his debentures and his agreement to sell a portion of the same constituted a use of a manipulative or deceptive device in violation of Rule X-105B5 of the General Rules and Regulations under the Securities Exchange Act of 1934, and Section 10b of the Securities Exchange Act of 1934.

Subsidiary to the issues stated above is the further issue of whether, by reason of his undisclosed agreements with Roland and with the banks to whom he pledged the debentures, Turner was a statutory underwriter within the meaning of the Securities Act.

A second subsidiary issue, and one which appears to be a question of first impression, is whether one subscriber to a securities issue may obtain the benefits of the civil remedy under Section 10b of the Securities Exchange Act by a suit against another purchaser of a part of the same issue, basing his suit upon conduct which would clearly give the corporate issuer a cause of action, where by contract the corporate issuer's rights inured to all purchasers.

SPECIFICATION OF ERRORS TO BE URGED.

1. The District Court erred in holding and deciding that Turner was not a statutory underwriter within the meaning of Section 4 of the Securities Act of 1933, Title 15 U.S.C.A. Section 77b(1) as it existed at the time of the transaction in question and thus Finding No. 10 [Rec. 114] is erroneous, for the reason that Turner had a secret undisclosed agreement with Roland whereby he bought one-fifth of debenture subscription for the benefit and account of Roland, and further, because Turner had arranged to pledge said debenture purchase to his banks and did in fact pledge them simultaneously with his purchase.

2. The District Court erred in holding that Turner's conduct in secretly agreeing to purchase $25,000.00 worth of his $125,000.00 debenture subscription for the benefit of Roland was not violative of Section 10b of the Securities Act of 1934 (15 U.S.C.A. Sec. 78b); was not violative of Rule 10(b)-5 of the Rules and Regulations of the Securities Exchange Commission (17 C.F.R. 240.10B-5); and was not violative of Section 17(a) of the Securities Act of 1933 (15 U.S.C.A. Sec. 77q) [Finds. Rec. 113].

3. The District Court erred in failing to find that Turner's pledge of the debentures and his resale of a portion of the same constituted a use of a manipulative or deceptive device in violation of Rule 10(b)-5 of the General Rules and Regulations under the Securities and Exchange Act of 1934, and Section 10b of the Securities and Exchange Act of 1934, 15 U.S.C.A Sec. 78(j).

4. The District Court erred in failing to hold that Turner did in fact violate Section 5 of the Securities

Act of 1933, 15 U.S.C.A. Section 77(e), in that Turner made use of means or instruments of transportation or communication in interstate commerce and of the mails to offer to sell a security in a manner that required a registration statement to have been filed as to such security, without a registration statement then being in effect.

5. The District Court erred in failing to hold that Counterclaimant Lundquist could assert a cause of action against Turner by reason of Turner's violations of Section 10b of the Securities and Exchange Act of 1934 and of Rule 10(b)-5 under the 1934 Act.

6. The District Court erred in failing to find that Turner violated the California Corporate Securities Law and that such violation constituted a violation of the Securities Exchange Act of 1934 and specifically Rule 10(b)-5 thereunder.

7. The District Court erred in rendering judgment for Turner and against Counterclaimant Lundquist on his Counterclaim.

8. To the extent that the Findings and Judgment of the District Court constitute a holding that the debenture did not constitute a security within the meaning of Rule 10(b)-5 or by definition under the Securities Exchange Act of 1934, said holding and finding are erroneous.

9. The District Court erred in making a finding in the Second Cause of Action [Find. No. 12, Rec. 114] since the Court expressly restricted all evidence to the issue of liability on the First Cause of Action and excluded evidence of damages and evidence bearing on the Second Cause of Action.

SUMMARY OF ARGUMENT.

A. THE TRIAL COURT IGNORED THE CASE LAW IMPLYING A PRIVATE CIVIL REMEDY FROM VIOLATION OF SECTION 10b AND RULE 10(b)-5.

B. TURNER'S CONDUCT VIOLATED RULE 10(b)-5, GIVING LUNDQUIST, AS A CO-PURCHASER OF THE SAME SECURITIES ISSUE, A CIVIL REMEDY AGAINST TURNER FOR DAMAGES.

C. THE CASES HOLD CONDUCT SIMILAR TO TURNER'S VIOLATES RULE 10(b)-5.

D. CONDUCT OF TURNER ALSO VIOLATED VARIOUS PROVISIONS OF THE SECURITIES ACT OF 1933 AND, THEREFORE, GAVE RISE TO A CAUSE OF ACTION UNDER SECTION 10(b)-5 OF THE SECURITIES EXCHANGE ACT OF 1934.

E. TURNER'S CONDUCT ENTITLED LUNDQUIST TO RECOVER IN A PRIVATE ACTION UNDER SECTION 10(b) AGAINST TURNER.

ARGUMENT.

A. The Trial Court Ignored the Case Law Implying a Private Civil Remedy From Violation of Section 10b and Rule 10(b)-5.

Federal Courts have given remedies to purchasers and sellers for violation of Section 10(b) of the Securities Exchange Act of 1934, which prohibits the use of manipulative and deceptive devices in securities transactions.

Ellis v. Carter, 291 F. 2d 270 (9th Cir. 1961);

Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2nd Cir. 1951);

Hooper v. Mountain States Sec. Corp., 282 F. 2d 195 (5th Cir. 1960);

Errion v. Connell, 236 F. 2d 447 (9th Cir. 1956);

Fratt v. Robinson, 203 F. 2d 627 (9th Cir. 1953).

Within the last 22 years, Federal Courts have concluded that, when Congress enacted the Securities Act of 1933 (15 U.S.C. Section 77a, *et seq.*) and a year later the Exchange Act of 1934 (15 U.S.C. Section 78a, *et seq.*), there should be spun off of certain sections of these companion acts by implication certain civil liabilities for those who violated this legislation. Private rights of action have been implied from sections of the Securities Act of 1933 and the Exchange Act of 1934 in numerous cases, including the following:

Osborne v. Mallory, 86 F. Supp. 869, 878, 879 (S.D. N.Y. 1949), which dealt with both Section 17 of the 1933 Act and Sections 10b and 15(c) of the 1934 Act;

Baird v. Franklin, 141 F. 2d 238 (2nd Cir. 1944), cert. denied in 323 U.S. 737, which dealt with Section 6(b) of the 1934 Act;

Remar v. Clayton Securities Corp., 81 F. Supp. 1014 (D.C. Mass. 1949), dealing with Sections 7(a) to 7(d) of the 1934 Act;

Slavin v. Germantown Fire Insurance Co., 174 F. 2d 799 (3rd Cir. 1949), dealing with Section 10(b) of the 1934 Act.

While the chief purpose of the 1933 and 1934 Acts was to regulate the issuance of securities and transactions upon the national stock exchanges, the courts have extended the civil remedies available to any person anywhere who has been defrauded in a securities transaction whether within or without the organized securities market.

Fratt v. Robinson, supra.

Section 10(b) of the Securities and Exchange Act of 1934 reads:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

By its terms, the foregoing Section 10(b) required a rule of the Securities and Exchange Commission to make the section operative. At this time the Securities Act of 1933 already had a general anti-fraud statute embodied in its Section 17(a), but it was limited to frauds in connection with the sale of securities. Very astutely the Commission in 1942 implemented Section 10(b) of the Exchange Act with its Rule X-10B-5 (now Rule 10(b)-5). This new rule borrowed the language of Section 17(a) of the Securities Act of 1933, but made it applicable to both sellers and purchasers. Rule 10(b)-5 reads:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

As can be seen, Rule 10(b)-5 presents a more comprehensive and less strict criterion of fraud than that of the common law. Subdivision (b) of the rule makes false statements and half-truths unlawful. It speaks not in terms of fraud and, as a consequence, little if

any proof of *scienter* appears necessary in order to establish a violation. On the other hand, subdivisions (a) and (c) of the rule denounce fraudulent devices, schemes, artifices, practices and courses of business which are used to defraud.

In summary, the factual basis for Lundquist's case is Turner's conduct of purchasing the Debentures with the secret agreement with Roland that he was purchasing part of the same for Roland and immediately pledging the Debentures to the banks as security for a loan used to purchase the Debentures, without informing the Company, Lundquist or any of the other purchasers of the Debentures of the secret pre-existing agreements to do so; and further, in pledging, transferring and agreeing to resell the Debentures in violation of Turner's express representation and agreement that he would not do so. The question to be answered, therefore, is whether these actions on the part of Turner constitute a violation of the Securities Act of 1933 and/or the Securities Exchange Act of 1934.

The elements of a cause of action under the above-quoted Section 10b are as follows:

1. A use of any means or instrumentality of interstate commerce or of the mails,

2. In connection with the purchase or sale of any security, whether registered on a national exchange or not, and

3. The use or employment in connection therewith of any manipulative or deceptive device or contrivance in contravention of the rules and regulations of the Securities and Exchange Commission.

The elements are satisfied in general as follows:

1. *Use of interstate commerce or of the mails.* Turner corresponded by mail and by interstate telephone with his bankers in Oklahoma to negotiate the $125,000 loan, and in addition mailed to the bankers in Oklahoma his finanacial statements, the Debentures purchased by him and certain supporting documents. All that is required to satisfy this element of the section is a showing that instruments of interstate commerce or the mails were used, and in connection with that use a fraudulent act occurred. It is not necessary that the mails or interstate commerce be used to transmit the actual fraudulent representation involved. *Errion v. Connell,* 236 F. 2d 447 (9th Cir. 1956); *Ellis v. Carter,* 291 F. 2d 270 (9th Cir. 1961). In any event, Turner testified that he mailed the December 1, 1960 Agreement, containing his representation, back to the company [R. T. 24, 25].

2. *In connection with the purchase or sale of any security, whether registered or not.* It is quite clear, under the facts of this case, that both Turner and Lundquist were purchasers of the Debentures herein and that Turner by prearrangement resold and pledged the Debentures. The actions previously described were therefore in connection with the purchase or sale of the Debentures. There can be no question that the Debentures were in fact securities within the meaning of Section 10(b), because the term "security" is defined by Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C.A. Section 78(c)(10), which provides that the term "security" includes debentures.

3. *The use or employment of any manipulative or deceptive device in contravention of the rules and regu-*

lations of the Securities and Exchange Commission. The appropriate rule here is rule 10(b)-5 of the General Rules and Regulations under the Securities Exchange Act of 1934, and the question then becomes whether or not the conduct of Turner violated the provisions of said rule. This question involves the basis of Lundquist's counterclaim, and will be discussed in detail next.

B. Turner's Conduct Violated Rule 10(b)-5, Giving Lundquist, as a Co-Purchaser of the Same Securities Issue, a Civil Remedy Against Turner for Damages.

The primary purpose of the Securities and Exchange Commission in adopting Rule 10(b)-5 was to prohibit fraud and other unlawful schemes in connection with the purchase or sale of securities. This rule extended a remedy to defrauded seller; the previous remedies were available only to defrauded buyers. *Hooper v. Mountain States Securities Corporation,* 282 F. 2d 195 (5th Cir. 1960). It is quite clear that in adopting this rule, the Commission intended to make its provisions broad and all-embracing. For example, the phrase "any person" is used twice in the rule. It is used in the first sentence to state that it shall be unlawful for "any person" to engage in the prohibited acts and it is used in the last part of the rule to state that any act which operates as a fraud or deceit on "any person" is prohibited. The rule extends its prohibitions to "any person" and extends its protection to "any person"; that is, it is available to both sellers and buyers, and is enforceable against both sellers and buyers.

As previously stated, the primary purpose of the rule is to prohibit fraud in connection with the pur-

chase or sale of securities. However, under clauses 1, 2 and 3, the rule reaches misleading or deceptive activities whether or not they are sufficient to sustain a common law action for fraud and deceit. *Hooper v. Mountain States Securities Corporation, supra; Ellis v. Carter, supra.* There need not be an affirmative misrepresentation, nor knowledge of the falsity of the statement made, nor bad faith intent to mislead, in order to make a cause of action under this rule. *Kohler v. Kohler Co.*, 319 F. 2d 634 (7th Cir. 1963). The word "fraud" as interpreted under the securities acts is given a broad, remedial definition and is not limited to the common law elements of deceit. *SEC v. Gulf Intercontinental Finance Corp.*, 223 F. Supp. 987 (S.D. Fla. 1963).

The narrow question then is whether or not Turner's conduct was in violation of any of the three clauses of Rule 10(b)-5 quoted above. It should be noted, however, that the antifraud provisions of the three clauses of the rule "are not intended as a specification of the particular acts or practices which constitute a fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others." *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), 1961-1964 C.C.H. Fed. Securities Law Rptr. Decisions 76,803. The Securities and Exchange Commission has taken the position that the three clauses of the rule should be considered as mutually supporting rather than mutually exclusive, and thus where a duty of disclosure can be established in a given case and a breach of that duty found, all three clauses of the rule may be violated, *In the Matter of Cady, Roberts & Co., supra.*

It should be noted, however, in considering the three clauses of Rule 10(b)-5, that is is only necessary to prove *one* of the prohibited actions in order to make out a case under the rule. *Stevens v. Vowell,* 343 F. 2d 374 (10th Cir. 1965).

Each and all of the three clauses of the rule have been violated by Turner's conduct as follows:

a. *Device, scheme or artifice to defraud.* The device consisted of the overall plan by Turner and Roland whereby Turner would acquire the Debentures with pre-existing scheme of immediately pledging the same to the City National Bank, Lawton, Oklahoma, and Liberty Bank of Oklahoma City, Oklahoma, and reselling a portion of the Debentures to Roland without the knowledge or consent of the Company, Lundquist or any other purchaser of the Debentures. This was in direct violation of the Agreement signed by Turner, Lundqust and all the other purchasers, which provided in part as follows:

> "10. *Representations of the Purchasers.* Each of you, severally and not jointly, represents and warrants, and in making this sale to you it is specifically understood and agreed, that the Notes being acquired by you are being acquired and will be taken and received for your private personal investment for your own account with no intention of reselling or otherwise distributing the Notes and that the shares of common stock which you may acquire upon the conversion of the Notes or any part thereof will also be acquired by you for your private personal investment for your own account with no intention of reselling or otherwise distributing such shares.

Turner's secret agreement to sell to Roland and to pledge the Debentures to the banks also violated certain provisions contained in the debenture instruments themselves. The Debentures provided in part as follows:

> "This Note is issued pursuant to and is entitled to the benefits of an Agreement dated as of Dedember 1, 1960, between the company and the Payee . . ."

The Debenture further provided:

> THE SALE OR ISSUANCE OF THIS NOTE IS AUTHORIZED BY PERMIT OF THE COMMISSIONER OR CORPORATIONS OF THE STATE OF CALIFORNIA AND IS SUBJECT TO ALL OF THE TERMS AND CONDITIONS SET FORTH IN SAID PERMIT, AND THE OWNER OF, OR PERSON ENTITLED TO THE NOTES AUTHORIZED TO BE SOLD AND ISSUED BY PARAGRAPH 1 of SAID PERMIT SHALL NOT CONSUMMATE A SALE OR TRANSFER OF SAID NOTES, OR ANY PORTION THEREOF, OR RECEIVE ANY CONSIDERATION THEREFOR PRIOR TO CONVERSION UNTIL THE WRITTEN CONSENT OR PERMIT OF THE COMMISSIONER OF CORPORATIONS SHALL HAVE BEEN OBTAINED SO TO DO."

Turner's secret agreement to sell to Roland and his receipt of the entire consideration by virtue of his pledge to the bank also violated these provisions.

b. *Make any untrue statement of a material fact or to omit to state a material fact.* Turner's conduct easily

comes within the purview of this section, because he made affirmative mis-statements of fact and also omitted to state material facts. It is clear that Turner affirmatively mis-stated material facts when he signed the Agreement, representing that the Debentures were taken for his private personal investment with no intention of reselling or otherwise distributing the Debentures and then immediately reselling and distributing a portion of the same to Roland and pledging all the Debentures to the Oklahoma banks. The omission to state material facts, of course, was Turner's silence with respect to the other purchasers of the Debentures; that is, his failure to reveal to them that he had a secret scheme to immediately resell and pledge the debentures. The materiality of the mis-statements and omissions to state material facts is proved by Lundquist's testimony to the effect that he relied upon Turner's representations contained in the Agreement, and relied upon the fact that all of the purchasers agreed not to resell or distribute the Debentures, and is also proved by Lundquist's further testimony that he would never have purchased the Debentures had he known of Turner's secret agreements with Roland and with the Oklahoma banks.

c. *Acts, practices or courses of business which operate as a fraud or deceit upon any person in connection with the purchase or sale of a security.* Turner testified in his deposition on June 28, 1965 [which was admitted into evidence on May 4, 1966, as Ex. P], on page 132 as follows:

> "Mr. Driscoll. A. Did Mr. Roland ever make a statement to you to the effect that some particular law applied or did not apply to the affairs or

operations of the company or to this debenture issue? A. No.

Q. He never told you that it was legal or illegal or anything like that? A. Not that I know.

Q. Well, I am not trying to trap you, sir, but you did say earlier that the $25,000 deal had to be kept between you and him, for reasons that you and he discussed. I believe you said that you and he had discussed it. A. Because he didn't want the board of directors to know about it."

Turner's conduct of secretly arranging to resell and pledge the Debentures in spite of his written agreement not to do so, and his failure to reveal the secret agreements to the Company's Board, to Lundquist and the other purchasers were acts which operated upon Lundquist and the other purchasers as a fraud or deceit in connection with the purchase and sale of the Debentures. The fraud consisted of Turner's representations and warranties in the Agreement that he would not resell or distribute the Debentures, and his failure to reveal the material facts concerning the secret agreements, which effectively operated to induce Lundquist to purchase the Debentures. As previously stated, Lundquist testified that he relied on these representations made by Turner in purchasing the Debentures. It is perfectly clear that all the purchasers who signed the Agreement except Turner did so with the express intent to hold the Debentures for investment only and not with the view toward reselling them. Turner had no intention of performing his representations at the time he made them. The lack of intention to perform these representations is what constitutes the fraud. *Keers & Co. v. American Steel & Pump Corp.*, 234 F. Supp. 201 (S.D. N.Y. 1964).

C. The Cases Hold Conduct Similar to Turner's Violates Rule 10(b)-5.

At the outset, it should be noted that section 10(b) and rule 10(b)-5 have been deemed by the Courts to be legislation which is remedial in nature and as such should be liberally construed. *Hooper v. Mountain States Securities Corp., supra; SEC v. Gulf Intercontinental Finance Corp., supra.* A number of cases have held that conduct similar to Turner's has constituted a violation of section 10(b) and/or rule 10-(b)-5. In the landmark case of *Kardon v. National Gypsum Co.,* 69 F. Supp. 512 (ED. Penn. 1946), the Court held that a private right of action was available in connection with section 10(b), and that purchasers of stock who failed to disclose secret agreement entered into between themselves and third parties were held to have violated the provisions of sections 10(b). The same situation is present in the instant case; that is, the failure of Turner to reveal his secret agreements with the Oklahoma banks and with Roland. The question is, as stated by the Court in the *Kardon* case, does the conduct in question involve a breach of a duty created by the Act (Section 10(b))? It is submitted that the section created a duty upon Turner to reveal the secret agreement he had made with Roland and the Oklahoma banks in order not to defraud and mislead Lundquist and the other purchasers of the Debentures, who relied on Turner's affirmations that he had no intent to resell the Debentures or transfer them in any manner.

Another recent case has held that the failure to disclose secret agreements in connection with the purchase or sale of securities violated Section 10(b) and/or Rule

10(b)-5. In *Stevens v. Vowell,* 343 F. 2d 374 (10th Cir. 1965), the plaintiff had been told by the defendants that the money he paid for certain securities would be used for specified purposes only. Defendants, however, at the time they made these representations, had agreements with third persons to use the money for entirely different purposes. Plaintiff was not advised of these agreements. The Court found that the plaintiff relied on defendants' representations, and that defendants had concealed certain critical facts from plaintiff concerning the agreements and had made misrepresentations of other facts, and that defendants had used instrumentalities of interstate commerce in their plans and designs, and that the instruments in question were securities within the meaning of 15 U.S.C.A. Section 78c(a)(10), and that the securities were unregistered, and that therefore the defendants had violated both Section 10(b) and Rule 10(b)-5. It is submitted that as previously shown, the same facts concerning reliance upon misrepresentations, concealment of material facts, and use of facilities of interstate commerce are present in the instant case, and that, therefore, the conclusion is inescapable that Turner had violated Section 10(b) and Rule 10(b)-5.

In the Ninth Circuit case of *Ellis v. Carter,* 291 F. 2d 270 (9th Cir. 1961), the defendant's misrepresentations concerning the control of the company in the sale of its securities, upon which the plaintiff relied in purchasing the stock, were held to violate Section 10(b) and Rule 10(b)-5.

One of Lundquist's theories of recovery was that he was defrauded and misled by reason of the fact that Turner breached the provisions of the Agreement, by

immediately reselling a portion of the Debentures in spite of his express representation that he would not do so. In the recent case of *M. L. Lee & Co. v. American Cardboard & Packaging Corp.*, 36 F.R.D. 27 (Ed. Penn. 1964), the Court held that a defrauded person has a valid claim under Section 10(b) and Rule 10(b)-5 where the fraud was in connection with a contract to purchase or sell securities. The fraud in that case consisted of a violation of certain contractual provisions, just as the fraud in the instant case is alleged to be in part Turner's violation of his agreement not to transfer the securities. It should further be noted that in the *M. L. Lee & Co.* case, the Court held that such a cause of action existed even without a consummated purchase or sale of securities; the mere negotiation for a purchase or sale, represented by a contract whose terms were breached, was enough to give rise to a cause of action.

In interpreting the phrase "in connection with the purchase or sale of any security," two recent cases have held that the misrepresentations which violate the rule are not limited only to those relating to the subject matter of the purchase, that is to say, the securities. In the case of *Glickman v. Schweickart & Co.*, 242 F. Supp. 670 (S.D. N.Y. 1965), the Court held that misrepresentations as to the *financing* of a purchase of securities were actionable under the rule, and that such misrepresentations are *not* limited to those relating to the subject matter of the purchase only. See also to the same effect, *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972 (S.D. N.Y. 1964). In the instant case, some of the misrepresentations did directly relate to the security, for example, the misrepresentations by

Turner that the Debentures would not be resold, and so are directly within the rule. However, other misrepresentations (or non-disclosures) related to the method of financing Turner's purchase of the Debentures, that is, his failure to reveal that the Debentures would be immediately pledged to the Oklahoma banks in order to provide the purchase price.

The case of *Keers & Co. v. American Steel & Pump Corp., supra,* involved similar facts. In that case, plaintiffs brought a minority interest in the stock of a certain corporation from one Benkert in reliance upon his oral promise that he would not sell his controlling interest in the corporation or take advantage of any other corporate opportunities flowing from his control, unless the opportunity for sale on equally advantageous terms was first made available to all of the stockholders of the corporation. Under the facts of that case, it was clear that Benkert honestly intended to fulfill his promise at the time he made it. However, when Benkert died, his executor violated his agreement. The Court held that there had been no fraud by Benkert because he had honestly intended to fulfill his promise when he made it. The Court stated, however, as follows:

> "Where representations are promissory in nature, as here, the promisee may not recover unless there is proof that at the time the promises were made the promissor had no intention in keeping them. The lack of intention to perform is what constitutes fraud."

The above-quoted language, it is submitted, is applicable to the instant case. When Turner made the representations in writing that he was acquiring the Debentures

for his own account with no intention of reselling or otherwise distributing the same, he had not the slightest intention of performing those representations. The facts in this case are clear. Turner made the representations that he would not resell or distribute the Debentures at a time when he had already entered into agreements to do exactly what he represented he would not do. That he had no intention of performing his representations is shown by his conduct of immediately pledging the Debentures and reselling the same to Roland. It is evident, therefore, that under the language in the *Keers* case quoted above, the representations of Turner were promissory in nature but at the time he made them, he had no intention of keeping such promises, and therefore, that is the gist of the fraud. As previously stated, the element of reliance is supplied by Lundquist's uncontradicted testimony that he would not have entered into the Agreement or purchased the Debentures if he had known that Turner was planning to resell and pledge the Debentures.

D. Conduct of Turner Also Violated Various Provisions of the Securities Act of 1933 and, Therefore, Gave Rise to a Cause of Action Under Section 10(b)-5 of the Securities Exchange Act of 1934.

The preceding section has shown that the acts of Turner described therein constitute the employment of manipulative and deceptive devices giving rise to a cause of action under rule 10(b)-5. However, there is another reason why Turner's conduct is actionable under section 10(b) and/or 10(b)-5, and that is because such conduct also violates various provi-

sions of the Securities Act of 1933. It must be emphasized, however, that is *not* necessary to establish a violation of the 1933 Act in order to make a cause of action under Section 10(b) of the 1934 Act. For example, it is not necessary to show that the resale by Turner of the Debentures in fact violated the private offering exemption under the 1933 Act, in order to come within Section 10(b). The requirements of Section 10(b) and Rule 10(b)-5 have been explained previously. However, Turner did in fact violate the 1933 Act, and this in turn is actionable under the 1934 Act.

Turner's resale of a portion of the Debentures to Roland violated Section 5 of the Securities Act of 1933, 15 U.S.C.A. 77e. That section provides that unless a registration statement is in effect as to security, it shall be unlawful for any person, directly or indirectly, to carry or cause to be carried through the mail or interstate commerce any such security for the purpose of sale or delivery after sale. As previously stated, there was no registration statement in effect in connection with the issuance of the Debentures, because the issue was exempted therefrom by reason of the "private offering exemption" contained in Section 4(2) of the Securities Act of 1933, U.S.C.A. Section 77d(b)(2), which exempts transactions by an issuer not involving a public offering. If, however, one is deemed to be an "underwriter" under the terms of Section 4(1) of said Act, 15 U.S.C.A. Section 77d(1), he is no longer protected by the private offering exemption, and is in violation of the Act.

"Underwriter" is defined in Section 2(11) of the 1933 Act, 15 U.S.C.A. Section 77b(11) as follows:

> "The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers to sell for an issuer in connection with, the distribution of any securities or participates or has direct or indirect participation in any such undertaking, or participates or has participation in the direct or indirect underwriting of any such undertaking."

A question has been raised as to whether or not Turner's pledge of the Debentures is within the meaning of the above-quoted section; that is, did the pledge make him an underwriter aside from the resale to Roland? This question has been answered affirmatively by the case of *SEC v. Guild Films Co.*, 279 F. 2d 485 (2nd Cir. 1960) in which the defendant banks, pledgees of unregistered securities raised this defense. In holding that a pledge transaction should be equated with a sale, the Court said, *supra,* at 489:

> "The banks cannot be exempted on the ground that they did not 'purchase' within the meaning of section 2(11). The term although not defined in the Act should be interpreted in a manner complementary to 'sale' which is defined in section 2-(3) [15 U.S.C.A. section 77b(3)] as including 'every * * * disposition of * * * a security or interest in a security for value * * *.'"

See S.E.C. Release No. 33-4552 (1962), C.C.H. Federal Securities Law Reporter, para. 2771 "In Public Offering Exemption" to the effect that whether a transaction is one not involving any public offering is es-

sentially a question of fact and necessitates a consideration of all surrounding circumstances. See, also, *In the Matter of Skiatron Electronics and Television Corp.*, 40 S.E.C. 236 (1960), [1961-1964 CCH Federal Securities Law Reporter, Decisions, para. 76,719, which held that a certain sale and pledge transaction was in violation of Section 5 of the Securities Act of 1933, 15 U.S.C.A. 77e].

In *S.E.C. v. Mono-Kearsarge Consolidated Mining Co.*, 167 F. Supp. 248 (D.C. Utah 1958), the Court said:

> "In effect, the term 'underwriters' as defined in the Act includes one who has purchased from any person directly or indirectly controlling an issuer or in direct or indirect common control with the issuer, with a view to the distribution of the security in question."

It is clear, therefore, from the foregoing that Turner was a statutory underwriter within the meaning of the foregoing rule because he purchased his stock from the issuer Company with the intention of immediately distributing and reselling the same to Roland. There is no evidence to show that Roland, when he took the Debentures, in any manner agreed to hold them for investment only and not with a view to resale or distribution. There was apparently nothing to prevent Roland from reselling his share of the Debentures to anyone he chose. An individual who obtains unregistered stock in a corporation from an issuer with a view to distribution thereof, is an "underwriter" within the meaning of 15 U.S.C.A. 77b(11), quoted above, *S.E.C. v. Bond and Share Corp.*, 229 F. Supp. 88

(D.C. Okla. 1963). The participation by Turner in the transaction was direct; however, even an indirect participation in the distribution would have been enough to bring him within the definition of an underwriter. *S.E.C. v. Culpepper,* 270 F. 2d 241 (2nd Cir. 1959).

It is submitted that the violations of the above-mentioned provisions of the Securities Act of 1933 are also actionable under Section 10(b) of the Securities and Exchange Act of 1934 when the ingredient of fraud is added thereto. In the case of *Fischman v. Raytheon Mfg. Co.,* 188 F. 2d 783 (2nd Cir. 1951), the plaintiffs, who had been induced to buy stock by reason of misstatements in a prospectus, were held to have stated a cause of action under rule 10(b)-5 without regard to whether such an action could be maintained under the appropriate section of the 1933 Act (Section 11, dealing with misstatements in a prospectus). The Court stated that when the element of fraud is added to conduct which is actionable under the section dealing with misstatements in a prospectus, the conduct becomes actionable under rule 10(b)-5 whether or not a suit could be maintained under Section 11. It is submitted that the same situation applies to conduct which is actionable under section 5 of the Securities Act of 1933, that is, Turner's conduct in reselling securities to Roland without a registration statement being in effect and in violation of the private offering exemption, and that when as here, the ingredient of fraud is added, Turner's conduct is actionable under rule 10(b)-5 whether or not a suit could be maintained for a technical violation of the private offering exemption.

E. Turner's Conduct Entitled Lundquist to Recover in a Private Action Under Section 10(b) Against Turner.

It is now firmly established that there is implied civil liability, that is, a private remedy judicially recognized, in connection with section 10(b) of the Securities Exchange Act of 1934, though the Act does not expressly provide for such liability, and even though the conduct may not be actionable in common law. *Kardon v. National Gypsum Co., supra; Ellis v. Carter, supra; Cooper v. North Jersey Trust Co., supra.*

The private right of action under the section and the rule derives from common law tort principles which impose liability for violation of a statute designed to prevent a particular type of harm, *Kardon v. National Gypsum, Co., supra; Osborne v. Mallory,* 86 F. Supp. 869 (S.D. N.Y. 1949); *McClure v. Borne Chemical Co.,* 292 F. 2d 824, 836 (3rd Cir. 1961). In those cases, recovery was allowed on the basis of the principle set forth in Restatement, Torts, §286. That section reads:

> "The violation of a legislative enactment by doing a prohibited act, or by failing to do a prohibited act, makes the actor liable for an invasion of an interest of another if:
>
> (a) The intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and,
>
> (b) The interest invaded is one which the enactment is intended to protect; and,
>
> (c) Where the enactment is intended to protect an interest from a particular hazard, the invasion of the interest results from that hazard; and,

(d) The violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action."

It has been established above that Turner violated Section 10(b) and Rule 10(b)-5 by doing an act prohibited by those enactments. The issue then is, whether having done this prohibited act, Turner is liable for an invastion of Lundquist's interest.

Each of the subdivisions of Restatement, Torts § 286 is satisfied by the facts of this case. As to (a), it is now clear that Section 10(b) and Rule 10(b)-5 were intended in part to protect the interest of the *buyer* of securities as an individual, *Osborne v. Mallory, supra; Fischman v. Raytheon Mfg.,* 188 F. 2d 783, 786-88 (2d Cir. 1951); *Matheson v. Armbrust,* 284 F. 2d 670, 674-675 (9th Cir. 1960). Lundquist is a buyer of securities.

As to (b), the enactments were intended to protect the interest of the investor in trading in a market free of deceptive statements, schemes and devices, *Kardon v. National Gypsum Co., supra,* at 514 (the enactment "discloses a broad purpose to regulate securities transactions of all kinds and, as a part of such regulation, the specific section in question provides for the elimination of all manipulative or deceptive methods in such transactions . . . ."). Lundquist is a buyer who engaged in a securities transaction, an "investor"—a member of the class for whose special benefit the statute was enacted, *Kardon, supra.,* at 514; *Cooper v. North Jersey Trust Co. of Ridgewood, New Jersey, supra.*

As to (c) and (d), Turner fraudulently misrepresented in connection with the sale of the Debentures to Lundquist that Turner was taking the same for investment, and Lundquist relied upon that representation in deciding to take his own allotment. The hazard the enactments contemplated has been effected by Turner—the misrepresentation resulted in a purchase of securities, a purchase which would not have been made but for the representation. This also establishes causation, that is, the violation was a legal cause of the invasion of Lundquist's interest.

Nor can it be successfully argued that the plaintiff can only sue his immediate seller, and not another buyer, such as Turner. Restatement, Torts, § 286 does not require "privity of contract," it has been held that "it would be an unwarranted constriction of the broad protection contemplated by the federal scheme of securities legislation to engraft upon that scheme a requirement (privity) that is neither part of the statute (Section 10(b)) nor a part of the governing common law tort principles contained in the restatement," *Miller v. Bargain City U.S.A., Inc.*, 229 F. Supp. 33, 37 (ED. Penn. 1964). Other cases have held that direct privity is not required, *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D. N.Y.); *Fischman v. Raytheon Mfg. Co., supra; Texas Continental Life Insurance Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960); reversed on other grounds, 307 F. 2d 242 (6th Cir. 1962). ("The defendants argue strenuously that plaintiff should be denied recovery because there was no privity between plaintiff and the defendant at the time of the sale. The court is of the opinion that such a fact is not material under the statute.")

Two recent cases have effectively disposed of this issue: *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (ED. Penn. 1964) and *New Park Mining Co. v. Cramer*, 225 F. Supp. 261 (S.D. N.Y. 1963). The Court in *Miller, supra,* said, at 38:

> "Nor is a defrauded buyer or seller limited to an action against the other party to the transaction."

In *Miller, supra,* there was no showing that the defendants were sellers, at 225 F. Supp. 36, but there was a showing that the defendants filed false reports and statements with the Securities and Exchange Commission, and the plaintiff, in reliance upon those reports, purchased securities on the over-the-counter market. It was held that it was not necessary that the defendants be the sellers to the defrauded buyer, rather, it was enough to sustain the cause of action based on Section 10(b) and Rule 10(b)-5 that the defendants did these acts "in connection with" the plaintiffs' purchase.

In *New Park Mining Co. v. Cramer, supra,* the Court said, at 266:

> "A purchaser or seller of stock is not limited under section 10(b) and rule 10(b)-5 to an action against the other party to the purchase or sale; he can sue a third person if in connection with the purchase or sale that person defrauded him."

This case held that where the defendants caused the plaintiff corporation to purchase 160,000 shares of another company, while taking shares free for themselves, it was not necessary that the corporation sue only the actual seller, because the action could be brought against the person who defrauded the corporation in connection with the sale. Lundquist purchased securi-

ties in reliance upon a representation by Turner that all the other shares sold would be taken for investment. In the *New Park* case *supra*, the plaintiff corporation purchased 160,000 shares in reliance upon the assumption that all other shares sold by the seller would be sold for a good and valuable consideration, and that the seller would take no action which would destroy the plaintiff corporation's investment.

Upon facts similar to those in the *Miller* case, *supra*, the Second Circuit unanimously held in *Fischman v. Raytheon Mfg. Co., supra*, that an action under the rule could be maintained by *common* stockholders who had bought their stock in reliance upon a false registration statement used in the sale of *preferred* stock. In *H. L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D. N.Y. 1960), it was held that defendants who prepared false financial statements as certified public accountants were not entitled to dismissal of the action on the ground that they did not participate in the sale induced by the use of the financial statement. In *Pettit v. American Stock Exchange*, 217 F. Supp. 21 (S.D. N.Y. 1936), a motion to dismiss the action against the Exchange was denied even though the Exchange was not the ultimate seller but was merely the conduit through which the sale was consummated.

It is apparent that the trend of the decisions is toward a literal interpretation of the language in Section 10(b), Rule 10(b)-5 by holding unlawful various acts "*in connection with* the purchase or sale of any security". With specific emphasis on the quoted language, it has been stated "that the outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock," *Cooper*

v. North Jersey Trust Co. of Ridgewood, N.J., supra (held that the purchaser could sue a pledgee who converted the plaintiff's stock even though the pledgee did not actually exchange consideration with plaintiff in a purchase and sale transaction). In *Glickman v. Schweickert & Co.,* 242 F. Supp. 670 (S.D. N.Y. 1965), a motion to dismiss by the defendant securities broker was denied where the complaint alleged that the broker represented to the plaintiff that the purchase of shares by means of a "factoring-device" was usual and proper, and did not inform the plaintiff that it violated the margin requirements of the Securities Exchange Act of 1934. In that case, the defendant argued similarly to *Cooper v. North Jersey Trust Co.* that the misrepresentation to which Section 10(b) relates is a misrepresentation relating to the subject matter of the purchase itself—the sale of securities, and since he made no misrepresentation as to the securities or their value, that there was no right of action under Section 10(b). The Court held that the words "in connection with" in Section 10(b) "need not be limited to misrepresentations relating to the subject matter of the purchase," *Id.* at 674, expressly following *Cooper v. North Jersey Trust Co.*

In short, it is apparent from the foregoing cases that any fraud "in connection with" a purchase of Securities is actionable under Rule 10(b)-5 even though the defendant is not a seller. This is so because (1) the Restatement section which is the basis for private actions under Section 10(b) and Rule 10(b)-5, does not require "privity", *i.e.*, does not require a buyer-seller relationship; (2) the recent cases cited above do not limit the enactments to suits against the other party

to the transaction, and (3) the trend of the decisions is toward an interpretation of the enactments which makes any fraud "in connection with" the purchase of securities actionable, even though the party defendant is not a seller who made misrepresentations directly relating to the security.

Summary and Conclusion.

The undisputed facts produced at the trial of this action should have resulted in a ruling that Lundquist was entitled to proceed to put on his evidence of causation and damages flowing from Turner's blatant violation of Rule 10(b)-5. Instead, the District Court ignored the many decisions granting a private civil remedy for violation of the Securities Acts and the Rules thereunder, and erroneously cut the trial short and found against Lundquist. The errors of the lower Court can and should be corrected by reversing the judgment and remanding the case with instructions to proceed to determine the amount of Lundquist's damages.

Respectfully submitted,

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Certificate.

I certify that, in the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT W. DRISCOLL